



COVID-19: A Triple Whammy for Emerging Market and Developing Economies

Kavaljit Singh



COVID-19: A Triple Whammy for Emerging Market and Developing Economies

Kavaljit Singh





Madhyam is an independent and non-profit policy research organization based in New Delhi. Our mission is to conduct high-quality research, stimulate democratic debate on important issues affecting people's lives and generate innovative solutions to today's – and tomorrow's – challenges.

Madhyam Briefing Papers present information, analysis and recommendations on various public policy issues.

Briefing Paper # 36

Author: Kavaljit Singh

Kavaljit Singh is Director of Madhyam.

April 23, 2020

Published by:

Madhyam

148, Maitri Apartments

Plot No.28, Patparganj, I.P. Extension

New Delhi: 110092

Phone: 91-11-43036919

Email: info@madhyam.org.in

Website: www.madhyam.org.in

Images courtesy of 123rf.com.

Creative Commons Attribution Non Commercial No Derivatives 3.0

Since this publication is meant for nonprofit, research and educational purposes, you are welcome to reproduce it provided the source is acknowledged. We will appreciate if a copy of reproduced materials is sent to us.

CONTENTS

| | | |
|-----|---|----|
| 1. | Introduction | 5 |
| 2. | A Sudden Stop in Capital Flows | 6 |
| 3. | LCBMs: No Insulation from Volatile Capital Flows | 7 |
| 4. | Spreads Widening, Defaults Increasing | 8 |
| 5. | Rapid Currency Depreciation and its Effects | 9 |
| 6. | The Big Commodity Demand Shock | 10 |
| 7. | Soaring Debt Burden | 11 |
| 8. | 2020: A Year of Sovereign Defaults? | 12 |
| 9. | The Growing Weight of Private Sector Creditors | 13 |
| 10. | Getting Debt Relief Right | 15 |
| 11. | The Need for Strong Fiscal Response | 17 |
| 12. | Why Financial Regulation Matters | 18 |
| 13. | Currency Swaps and Repo Facility: No Game Changer | 18 |
| 14. | A Well-resourced and Reformed IMF | 19 |
| 15. | ODA Has a Unique Role to Play | 20 |
| 16. | No Country is an Island | 20 |

Introduction

Even though the rapid spread of the novel coronavirus (COVID-19) pandemic in the US and European Union has captured the world's attention, one should not lose sight of the pandemic and its associated health, economic and financial stability challenges in the rest of the world. As the COVID-19 pandemic advances globally, Africa and South Asia are witnessing a surge in the number of new cases lately, and these regions could soon become its next epicenters in the coming weeks.

The emerging market and developing economies¹ (EMDEs) are facing a triple whammy massive capital outflows, a sudden stop in economic activity, and collapse in commodity prices on top of a public health crisis caused by COVID-19.

Since the late-January, all major macroeconomic and financial indicators have been deteriorating across EMDEs with the tightening of global financial conditions, deep supply and demand shocks, and the threat of a global recession.

Falling external demand in commodities and travel bans have adversely affected a large number of EMDEs that are heavily dependent on commodity exports and tourism. While supply chain disruptions have severely affected Mexico and ASEAN economies, having a high degree of integration into the regional production systems. Remittances are likely to fall across all EMDEs due to economic contraction in advanced economies.

Besides, emerging markets such as India, Indonesia, South Africa, Malaysia, Argentina, and Turkey have imposed lockdowns and social distancing measures to contain the spread of the virus. These economies are experiencing a sharp contraction in economic activity that would last throughout the second half of 2020. The downside risks are significant for emerging markets and are expected to rise further over the coming weeks as the number of confirmed COVID-19 cases accelerates in South Asia, Africa, and South America.

The weaker external demand, coupled with strict enforcement of lockdowns and social distancing measures, would have negative impacts on jobs, private consumption, and investment across EMDEs, thereby impairing economic growth and living standards. Except for China and Saudi Arabia, all major EMEs are heading towards a recession or would witness sharply lower growth this year. It is hard to see any emerging market performing better in the face of external shocks and curtailment of economic activity due to the implementation of lockdowns and other social distancing measures.

More worryingly, public health infrastructure in EMDEs is grossly inadequate to contain the spread of COVID-19. Unlike advanced economies, most EMDEs lack large financial buffers and strong monetary and fiscal capacity to cushion the economic and financial impacts of the COVID-19 pandemic. The problem is further exacerbated by a lack of social protection and safety nets to protect the poorest and most vulnerable groups from the COVID-19 crisis.

Therefore, the combined effects of health pandemic, shutdowns, financial volatility, and commodity price declines are catastrophic for EMDEs and would seriously undermine their ability to achieve the UN Sustainable Development Goals (SDGs).

1. The IMF's World Economic Outlook classifies a large and diverse group of 150 economies as EMDEs that also includes 10 members of G20.

A Sudden Stop in Capital Flows

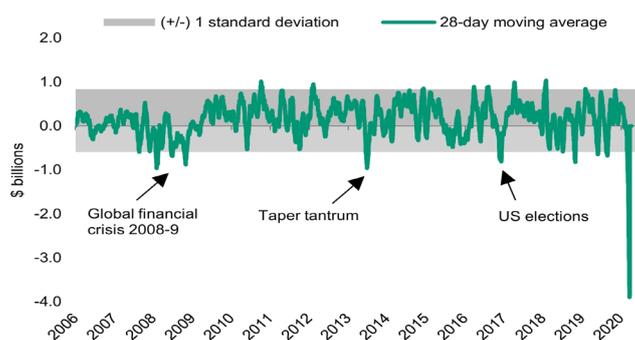
COVID-19 shock has caused a sudden stop in capital flows to almost all emerging markets. An increase in global risk aversion and financial uncertainty prompted foreign portfolio investors (FPIs) to dump emerging-market financial assets en masse and move their capital to safe-haven assets such as US treasury bonds, the dollar, and cash.

Emerging markets witnessed record net portfolio outflows during January-March 2020. According to data from the International Institute of Finance, outflows from emerging markets totaled a record \$83.3 bn in March alone.² The IIF data further reveals that the total portfolio outflows from emerging markets were \$97 bn during January 1-April 8, 2020.³

Except for China, all major EMEs (such as Brazil, India, Mexico, Russia, South Africa, and Thailand) witnessed large capital outflows triggered by panic selling by foreign portfolio investors. In India, for instance, foreign portfolio investors pulled out a record Rs.1182 bn (US\$16 bn) from financial markets in March.⁴ In the case of South Africa and Thailand, outflows were more than 1 percent of GDP.⁵ It is important to note that capital outflows from emerging markets were not restricted to equity markets; significant outflows from bond markets also took place during February-March 2020. Panic selling by FPIs did not spare even EM local currency bond markets.

There is no denying that past global turbulences also led to capital outflows from EMEs, but what is unique this time is the scale and speed of outflows. The COVID-19-induced capital outflows are significantly larger than the last two major episodes of global turbulence the 2008 global financial crisis and the 2013 “taper tantrum” episode (Figure 1). The IIF data based on a 28-day moving average reveals that the daily net portfolio outflows by foreign investors exceeded \$2.5 bn.⁶

Figure 1: Unprecedented Capital Outflows from Emerging Markets
(Net Non-resident Purchases of Stocks of Bonds, \$ bn)



Sources: Institute of International Finance and Moody's Investors Service.

2. Elina Ribakova, Benjamin Hilgenstock and Jonathan Fortun, “Macro Notes – 2020 Capital Flows Outlook for Emerging Markets,” Institute of International Finance, April 8, 2020. Available at: <https://www.iif.com/Publications/ID/3826/Macro-Notes-2020-Capital-Flows-Outlook-for-Emerging-Markets>.
3. Ibid.
4. Kavaljit Singh, “Coronavirus Triggers Large Capital Outflows from India,” Policy Brief # 6, Madhyam, April 3, 2020. Available at: <https://www.madhyam.org.in/coronavirus-triggers-large-capital-outflows-from-india>.
5. Global Financial Stability Report (2020), International Monetary Fund, April 2020, p.12. Available at: <https://www.imf.org/en/Publications/GFSR/Issues/2020/04/14/global-financial-stability-report-april-2020>.
6. Sergi Lanau and Jonathan Fortun, “Economic Views – The COVID-19 Shock to EM Flows,” Institute of International Finance, March 17, 2020. Available at: <https://www.iif.com/Publications/ID/3802/Economic-Views-The-COVID-19-Shock-to-EM-Flows>.

A massive exodus of capital from emerging markets has put considerable negative pressure on their currencies as the demand for the US dollar has risen sharply. It is increasing the cost of dollar debt funding across emerging markets. Hence, the EMEs with large external financing needs (such as Turkey, Argentina, South Africa, Chile, and Colombia) are particularly vulnerable to capital outflows.

Deteriorating global financing conditions with large net outflows would necessitate a substantial drawdown of forex reserves. It could force a large adjustment in the current account, as seen during the sudden stop episodes in Argentina and Turkey in 2018.

Portfolio flows to emerging markets are expected to remain relatively subdued in 2020. The IIF projects that annual portfolio flows to emerging markets would be \$444 bn in 2020, less than half of \$937 bn in 2019.⁷

LCBMs: No Insulation from Volatile Capital Flows

In the wake of the COVID-19 crisis, panic selling by foreign portfolio investors has caused substantial disruption in EM local currency bond markets (LCBMs), particularly in Asia. Because of massive sell-offs, the local currency bond spreads have increased along with the widening of credit default swap spreads.

A recent study by the Bank for International Settlements noted that “borrowing in domestic currency has not insulated EMEs from currency movements, as sharp currency declines have set in motion amplifying dynamics in the financial system between record portfolio outflows in EME bonds and the spike in EME local currency bond spreads over international benchmarks.”⁸

Those EMDEs having sizeable foreign ownership of local currency government (and corporate) bonds are particularly vulnerable to heightened risk aversion on the back of the COVID-19 pandemic. Although China and India are the largest issuers of EMDE domestic currency bonds, both countries allow limited participation of foreign portfolio investors in LCBMs. In India, for instance, FPIs cannot own more than 6 percent of the outstanding stock of local currency government bonds and 9 percent of local currency corporate bonds in the fiscal year 2019-20. But most EMDEs do not impose such limits. For instance, FPIs hold more than 30 percent in the LCBMs of Peru, Indonesia, South Africa, Mexico, Poland, and Colombia.

The LCBMs were developed in EMDEs in the aftermath of the currency crises of the 1990s. The policy objectives to develop LCBMs were to reduce foreign currency borrowing, lessen exchange rate risks, and decouple domestic bond markets from volatile global capital flows. Unlike foreign currency bonds, foreign investors are exposed to exchange rate risk on their investments in local currency bonds. The establishment of LCBMs in EMDEs has been supported by various international initiatives, including G20’s LCBM Action Plan (2011) and World Bank’s Maximizing Finance for Development agenda.

Post the 2008 crisis; the local currency bond markets witnessed rapid growth across EMEs. According to a staff note prepared jointly by the IMF and World Bank for G20, the total stock of EM debt in

7. Robin Brooks, Elina Ribakova, Sergi Lanau, and Jonathan Fortun, and Benjamin Hilgenstock, “Capital Flows Report: Sudden Stop in Emerging Markets,” April 09, 2020. Available at: <https://www.iif.com/Publications/ID/3841/Capital-Flows-Report-Sudden-Stop-in-Emerging-Markets>.

8. Boris Hofmann, Ilhyock Shim, and Hyun Song Shin, “Emerging market economy exchange rates and local currency bond markets amid the Covid-19 pandemic,” BIS Bulletin, No. 5, Bank for International Settlements, April 7, 2020. Available at: <https://www.bis.org/publ/bisbull05.htm>.

local currency was \$22.4 trillion in 2018.⁹ Along with an increase in the issuance of domestic debt, the foreign ownership of local currency bonds increased. The foreign holdings in EM local currency government bonds were 19 percent on average in 2018.¹⁰

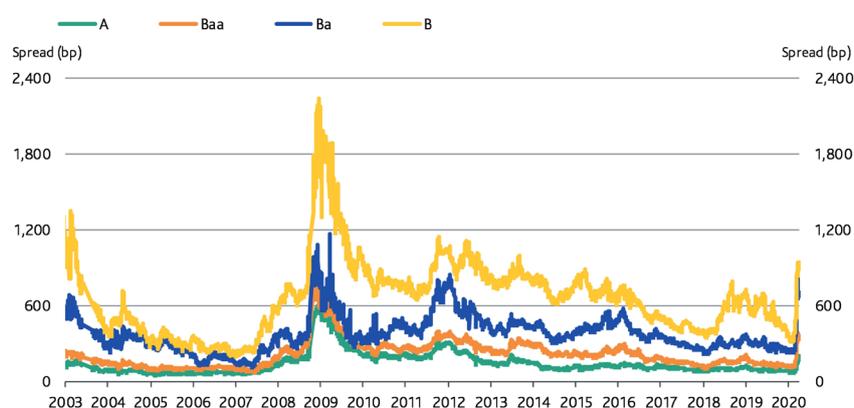
Since EMDEs have not been able to insulate their LCBMs from volatile capital outflows in the wake of COVID-19 pandemic, it raises an important question: to what extent the participation of foreign portfolio investment in LCBMs should be allowed?

Spreads Widening, Defaults Increasing

In credit markets, EMDE bond spreads¹¹ (for both sovereign and corporate) have been sharply widening since the onset of the COVID-19 pandemic. The spreads on dollar-denominated emerging market sovereign bonds have widened from a low of 300bp in early February to 700 basis points in late March — closer to levels seen during the 2008 global financial crisis (Figure 2). Ecuador’s Emerging Markets Bond Index (EMBI) spread skyrocketed from 1531 to 2879 basis points during March 4-10, 2020.

There are nearly 20 EMDEs (including Angola, Ecuador, and Zambia) whose dollar-denominated sovereign bonds are now trading at distressed levels (over 1000 basis points), indicating a wave of potential sovereign defaults. Even before the COVID-19 crisis, Venezuela and Lebanon had already defaulted on their sovereign bonds.

Figure 2: Emerging Markets Median Credit Spreads (3-5 year duration)



Source: Moody’s Investors Service, 2020.

The sharp rise in credit spreads would put upward pressure on borrowing costs of sovereign and corporate borrowers in EMDEs. Consequently, it would lead to higher refinancing costs and would constrain the issuance of new debts by EM sovereigns as well as corporates. The countries most at risk of debt defaults are energy-exporters in Africa and the Middle East, hit by a double whammy of falling oil prices and the COVID-19 outbreak.

9. Staff Note for the G20 International Financial Architecture Working Group, IMF and World Bank, January 27, 2020. Available at: <http://documents.worldbank.org/curated/en/129961580334830825/pdf/Staff-Note-for-the-G20-International-Financial-Architecture-Working-Group-IFAWG-Recent-Developments-On-Local-Currency-Bond-Markets-In-Emerging-Economies.pdf>.

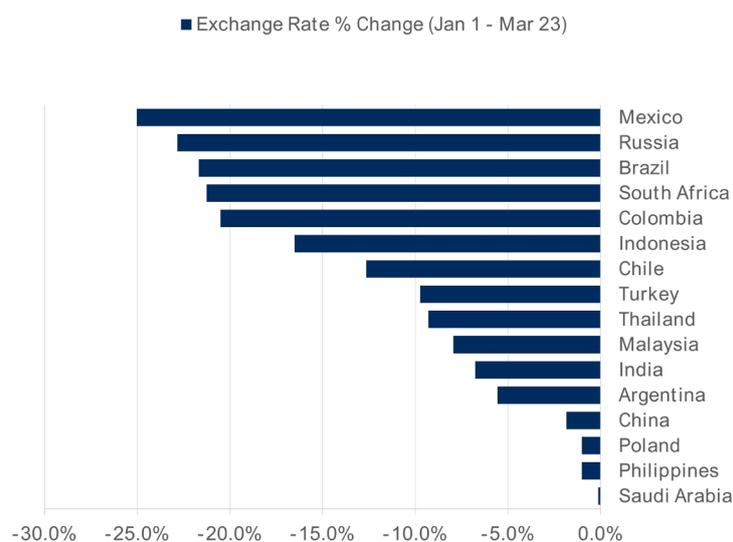
10. Ibid.

11. A credit spread is the difference in yield of two different bonds of the same maturity. EM bonds are usually compared to US Treasuries (considered to be risk free) to assess their credit risk. 1 percent difference in yield is equal to a spread of 100 basis points.

Rapid Currency Depreciation and its Effects

The emerging market currencies experienced sharp declines as frightened foreign investors dumped equities, bonds, and other financial assets across EMEs. Figure 3 shows data on exchange rate depreciation in selected EM currencies from January 1 to March 23, 2020. In the case of Mexico, Russia, Brazil, South Africa, and Colombia, the currency depreciation was more than 20 percent. The crude oil price crash also added to currency depreciation in Mexico and Russia.

Figure 3: Currency Depreciation in Emerging Markets



Sources: Bloomberg, S&P Global Ratings.

The Indonesian rupiah's depreciation exceeded more than 15 percent during this period. In comparison, the Indian rupee depreciation was relatively modest (7 percent), partly due to strong intervention in forex markets by the central bank.

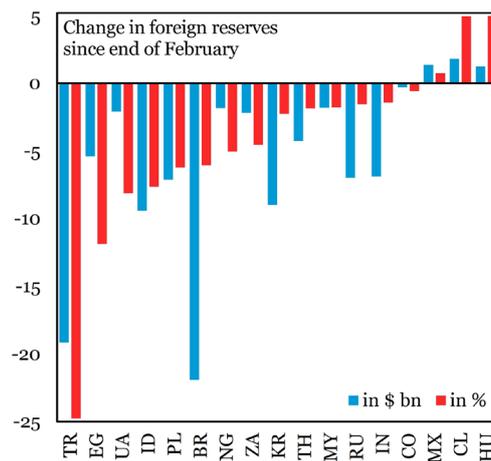
There is no denying that EM central banks can and do intervene in foreign exchange markets to mitigate the impact of capital outflows on domestic currencies. However, such interventions are considered to be most effective for a short duration (less than a month). Otherwise, the central banks run the risk of depleting substantial forex reserves without much impact besides inducing financial fragility.

Not many EM central banks give real-time information on actual interventions in forex markets. However, substantial forex reserves losses are inevitable if central banks directly intervene in forex markets to stem a decline in their currencies. China, for instance, spent roughly \$1 trillion of forex reserves defending its currency in 2015.

Figure 4 shows reserve losses in selected EMEs since the end of February 2020. According to the IIF, many central banks (in Brazil, Indonesia, Russia, Turkey, and Ukraine) introduced lender-of-last resort forex facilities besides deployed a wide range of measures from direct interventions to forwards, swaps and repos to mitigate excessive volatility in their currencies.¹²

12. Elina Ribakova, Benjamin Hilgenstock, Jonathan Fortun, and Esther Grambs, "Macro Notes – COVID-19 Policy Response in Emerging Markets," April 15, 2020. Available at: <https://www.iif.com/Publications/ID/3845/Macro-Notes-COVID-19-Policy-Response-in-Emerging-Markets>.

Figure 4: Many Emerging Markets Suffered Forex Reserve Losses



Source: Institute of International Finance, 2020.

The sharp depreciation of EM currencies not only contributes to inflationary pressures but also precipitates more capital outflows, as witnessed during the 2013 “taper tantrum” episode.

For EM corporates with heavy reliance on US dollar debt, the currency depreciation would increase interest payments costs in local currencies and would make them vulnerable to currency mismatches, particularly at a time when the COVID-19 outbreak is affecting their cashflows and business operations. In Indonesia, for instance, realty firms borrow funds in US dollars from the offshore bond markets to finance their projects, but their revenues are in rupiah. The rupiah depreciation by more than 15 percent would negatively affect realty firms’ liquidity and profitability.

The Big Commodity Demand Shock

A sudden stop in economic activity around the world has shattered the global demand for oil along with prices. Amid falling oil demand, an oil price war — triggered by Saudi Arabia with Russia over proposed oil production cuts — further contributed to a steep decline in oil prices. As a result, crude oil prices have fallen more than 60 percent since the beginning of 2020.

A sharp drop in global oil and commodity prices is weakening the finances of several EMDEs dependent on commodity exports. Commodity dependence is particularly high in countries such as Angola, Iraq, Nigeria, and Azerbaijan, where oil exports account for close to 90 percent of total export revenues. The consequences of a collapse in commodity prices would be far-reaching for EMDE commodity exporters as it would negatively affect their government revenues, foreign-exchange earnings, social spending, and overall economic growth prospects.

Unlike a few countries in the Middle East, the bulk of oil exporters from Africa and Latin America do not have large financial buffers in the form of sovereign wealth funds. If oil prices do not recover from their current levels by the end of 2020, some commodity-exporting EMDEs would default on their external debts.

Although falling oil prices are negative for a large number of commodity exporters, a few oil-importing EME (such as India and Turkey) are expected to benefit from lower prices. However, the benefits from lower oil prices for such economies would not be significant given muted domestic demand for oil products this year owing to COVID-19 pandemic and subsequent lockdowns.

On April 13, an agreement was reached among global oil producers to cut crude production by 9.7 million barrels per day, but initial market trends indicate that the cuts have not helped in the stabilization of crude oil prices.

Soaring Debt Burden

In the wake of COVID-19 pandemic, large portfolio outflows and the resulting currency depreciations are posing a significant liquidity and solvency risk to those EM sovereigns, banks, and non-financial corporates that are heavily reliant on foreign-currency borrowings. An overarching concern is that financial stresses could turn into self-reinforcing feedback loops, as seen recently in Argentina.

The years after the 2008 crisis saw sharp increases in EMDE foreign currency debt as zero interest rates and massive levels of quantitative easing by global central banks drove portfolio investors to hunt for higher yields across emerging markets. Post-crisis, the EM sovereign, and non-financial corporate bond markets expanded at a rapid pace with the increased popularity of the “carry trade”¹³ strategy in the global investment community. It drove money into EM debt securities, offering high-interest rates. As a result, the EM sovereign bond issuance soared from \$169.0 bn in 2009 to \$304 bn in 2019.¹⁴

According to the IIF, the emerging market foreign-currency denominated debt (mostly in US dollars) currently stands at \$5.3 trillion.¹⁵ In addition, foreign portfolio investors bought a significant portion of local currency debt in EMDEs. Within Asia, for instance, foreign holdings of local currency sovereign bonds were 38 percent in Indonesia and 25 percent in Malaysia in early 2020.

The capital outflows and currency depreciations pose an additional source of risk to banks too. The EMDE banks having high exposure to foreign currency loans or reliant on foreign currency funding would face additional pressures in terms of higher foreign currency funding costs, rise in non-performing loans due to unhedged foreign currency loans to corporates, and lower profitability prospects.

In particular, African countries with dollarized banking systems need to watch out. Close to 90 percent of bank deposits and loans are denominated in the US dollar in the Democratic Republic of the Congo, 42 percent in Angola, and more than 30 percent in Tanzania, Uganda, and Namibia. Approximately 25 percent of the banking system in Nigeria, Ghana, and Egypt is dollarized.¹⁶

Among the EMDE non-financial corporates, most vulnerable are those having unhedged foreign currency exposures of their borrowings.

13. Borrowing in dollar or yen thanks to near-zero interest rates and investing in an EM asset that provides a higher rate of return.

14. Avantika Chilkoti, “Private Creditors Become Crucial to Emerging Markets’ Debt Relief,” The Wall Street Journal, April 15, 2020. Available at: <https://www.wsj.com/articles/private-creditors-crucial-to-emerging-markets-debt-relief-11586941654>.

15. Emre Tiftik and Khadija Mahmood, “Global Debt Monitor: COVID-19 Lights a Fuse,” Institute of International Finance, April 6, 2020. Available at: <https://www.iif.com/Publications/ID/3839/April-2020-Global-Debt-Monitor-COVID-19-Lights-a-Fuse>. https://www.iif.com/Portals/0/Files/content/Research/Global%20Debt%20Monitor_April2020.pdf.

16. Moody’s Investors Service, “Capital outflows will weigh on African banks’ financial metrics,” April 9, 2020. Available at: https://www.moody.com/upgrades?ReturnUrl=http%3a%2f%2fwww.moody.com%2fviewresearchdoc.aspx%3fdocid%3dPBC_1223486%26lang%3den%26cy%3dglobal.

**Table 1: IDA-eligible Countries in Debt Distress
(Assessed by World Bank/IMF as of end-2019)**

| | External Debt | Overall Debt | Date of Publication of Debt Sustainability Assessment |
|-----------------------|----------------------|---------------------|--|
| Grenada | In Distress | In Distress | Jul 2019 |
| Mozambique | In Distress | In Distress | May 2019 |
| Republic of Congo | In Distress | In Distress | Jul 2019 |
| São Tomé and Príncipe | In Distress | In Distress | Oct 2019 |
| Somalia | In Distress | In Distress | Aug 2019 |
| South Sudan | In Distress | In Distress | Jun 2019 |
| Sudan | In Distress | | Dec 2017 |
| The Gambia | In Distress | In Distress | May 2019 |
| Zimbabwe | In Distress | | Jul 2017 |

Sources: World Bank, IMF, Fitch Ratings.

Table 1 provides a list of IDA-eligible countries in debt distress as per debt sustainability analyses under the Joint Bank-Fund Debt Sustainability Framework for Low-Income Countries.

On the other hand, a significant number of middle-income countries have large external financing needs through 2020 that cannot be managed with low forex reserves. Take the case of Turkey, which is heavily dependent on foreign financing. Turkey’s forex reserves at \$89 bn are inadequate to meet its total external financing requirements of about \$170 bn in 2020, making the country vulnerable to a classic balance-of-payments crisis.

Even those middle-income economies that are in a position to meet the bulk of their external financing would also need additional resources to support their COVID-19 relief and recovery efforts.

The EMEs with a higher debt burden would find it extremely difficult to refinance their existing external debt. The IIF estimates that the EMEs would need to refinance \$730 bn in foreign currency debt through the end-2020.¹⁷ This year, the refinancing needs in the US dollar are very high - more than 80 percent.¹⁸

2020: A Year of Sovereign Defaults?

In the coming weeks, emerging markets keen to raise fresh funds from international bond markets for coronavirus recovery efforts or general budgetary purposes would face prohibitive costs. Because of the COVID-19 shock, the primary market for issuance of new foreign-currency debt by EMEs has sharply contracted, from \$100.05 bn in January to \$20.26 bn in March.¹⁹

On April 6, 2020, Indonesia raised a \$1.65 bn through 10.5-year dollar-denominated “Pandemic Bonds” at a coupon rate of 3.9 percent, a premium of 105 basis points over a similar 10-year bond issued

17. Ibid.

18. Emre Tiftik and Khadija Mahmood, “Global Debt Monitor: COVID-19 Lights a Fuse,” Institute of International Finance, April 6, 2020. Available at: <https://www.iif.com/Publications/ID/3839/April-2020-Global-Debt-Monitor-COVID-19-Lights-a-Fuse>.

19. Frances Yoon and Avantika Chilkoti, “Bond Investors Are Back, Even in Indonesia,” Wall Street Journal, April 7, 2020. Available at: <https://www.wsj.com/articles/bond-investors-are-back-even-in-indonesia-11586263345>.

in January. Indonesia is a rare exception in this regard. For the non-investment grade EM sovereigns with significant international bond maturities this year, it would be challenging to place new debt or rollover existing debt in the global capital markets at reasonable terms.

The middle-income countries such as Bahrain, Honduras, Sri Lanka, Turkey, and Tunisia have large upcoming international bond maturities relative to their forex reserves (Table 2). Not many have arranged pre-financing of their forthcoming international bond redemptions.

Table 2: Upcoming International Bond Maturities (% of 2019 Official Forex Reserves)

| | Q1 2020 | Q2 2020 | Q3 2020 | Q4 2020 | Q1 2021 | Total through Q 2021 |
|--------------------|---------|---------|---------|---------|---------|----------------------|
| Bahrain | 26.8 | 0.0 | 0.0 | 0.0 | 20.9 | 47.7 |
| Fiji | 0.0 | 0.0 | 0.0 | 21.1 | 0.0 | 21.1 |
| Montenegro | 0.0 | 0.0 | 0.0 | 0.0 | 17.2 | 17.2 |
| Sri Lanka | 0.0 | 0.0 | 0.0 | 15.1 | 0.0 | 15.1 |
| Croatia | 0.0 | 0.0 | 6.2 | 0.0 | 7.5 | 13.7 |
| Honduras | 0.0 | 0.0 | 0.0 | 11.4 | 0.0 | 11.4 |
| Tunisia | 0.0 | 11.0 | 0.0 | 0.0 | 0.0 | 11.0 |
| Turkey | 0.0 | 5.2 | 0.0 | 0.7 | 4.5 | 10.4 |
| Albania | 0.0 | 0.0 | 0.0 | 7.5 | 0.0 | 7.5 |
| Costa Rica | 0.0 | 0.8 | 2.8 | 3.4 | 0.0 | 6.9 |
| Ukraine | 0.0 | 0.0 | 6.4 | 0.0 | 0.0 | 6.4 |
| Dominican Republic | 0.0 | 5.7 | 0.0 | 0.0 | 0.0 | 5.7 |
| Morocco | 0.0 | 0.0 | 0.0 | 5.7 | 0.0 | 5.7 |

The table includes all EM sovereigns where upcoming maturities are equivalent to more than 5% of foreign reserves. Q1 2020 figures do not include already matured bonds up to and including March 27, 2020. Croatia and Montenegro are fully euroized, which eliminates currency risk.

Sources: Bloomberg, national authorities, and Moody's Investors Service.

Persistent outflows and tightening in external financing conditions in the coming weeks could unleash a wave of sovereign downgrades and defaults. Fitch Ratings has downgraded 18 EM sovereigns so far in 2020. A default is imminent in Ecuador and Suriname. Several non-investment grade EMDEs could enter into a sovereign debt crisis this year.

The Growing Weight of Private Sector Creditors

Over the past two decades, the decline in the availability of concessional lending from bilateral and multilateral creditors pushed EMDE sovereigns to raise funds in either foreign or local currency from private bondholders, commercial banks, private financial institutions (such as asset management firms and hedge funds), and other private sector entities.

The stock of EMDE sovereign debt held by nonresidents substantially grew as they bought bonds and securities offered in domestic or international capital markets. By 2018, the share of EMDE government debt held by nonresidents had grown to 43 percent of GDP.²⁰

20. M. Ayhan Kose, Peter Nagle, Franziska Ohnsorge and Naotaka Sugawara "Global Waves of Debt: Causes and Consequences," World Bank. Available at: <https://www.worldbank.org/en/research/publication/waves-of-debt>.

With EMDE sovereign borrowers raising more money through bonds than loans, the composition of their debt has considerably changed in recent years. Another notable development is a surge in short-term debt.

Table 3 provides the IIF estimates on the debt service of the long-term external public debt of 126 EMDEs (excluding China) comprising of 59 IDA-only countries²¹, 17 blend countries²², 15 large emerging markets²³, seven lower middle-income countries²⁴ (LMCs), and 28 upper middle-income countries²⁵ (UMCs). These debt service payment statistics of 2020 reveal interesting insights, some of which are summarized below:

The total external debt service of 126 EMDEs is \$462.8 bn, out of which \$351.6 bn (75.9%) is owed by large EMs, \$51.4 bn (11.1%) by UMCs, \$22.5 bn (4.8%) by LMCs, \$22.6 bn (4.8%) by IDA-only countries, and the remaining \$14.7 bn (3.1%) by blend countries.

Table 3: External Debt Service of Low and Middle-Income Countries (ex-China), 2020 (\$bn)

| | IDA-only (59) | Blend countries (17) | Large EMs (15) | Other LMC (7) | Other UMC (28) | Total |
|---------------------|---------------|----------------------|----------------|---------------|----------------|--------------|
| Public debt* | 21.7 | 13.6 | 349.8 | 22.3 | 50.9 | 458.4 |
| Bilateral | 7.3 | 4.2 | 21.1 | 8.8 | 9.2 | 50.7 |
| Multilateral | 6.2 | 4.1 | 32.1 | 5.1 | 14.9 | 62.5 |
| Private | 8.2 | 5.3 | 296.5 | 8.4 | 26.8 | 345.2 |
| Bonds | 2.7 | 3.0 | 155.2 | 1.5 | 18.0 | 180.3 |
| Commercial Banks | 2.5 | 1.9 | 80.9 | 4.3 | 6.3 | 95.9 |
| Other private | 2.9 | 0.4 | 60.5 | 2.7 | 2.6 | 69.1 |
| IMF debt** | 0.9 | 1.1 | 1.8 | 0.2 | 0.5 | 4.4 |
| Total | 22.6 | 14.7 | 351.6 | 22.5 | 51.4 | 462.8 |

*Includes publicly guaranteed debt.

**April-December 2020.

Source: The Institute of International Finance, 2020.

- Out of a total of \$462.8 bn debt service payments, only \$50.7 bn (10.9%) is owed to bilateral creditors, followed by \$62.5 bn (13.5%) to multilateral creditors (excluding IMF), and the remaining \$345.2 bn (74.5%) is owed to private-sector creditors. The total IMF debt service amounts to \$4.4 bn during April-December 2020.
- Out of a total of \$22.6 bn debt service payments of IDA-only countries, \$8.2 bn (36.2%) is owed to private creditors, \$7.3 bn (32.3%) to bilateral creditors, and the rest \$7.1 bn (31.4%) to multilateral creditors.

21. The list of 59 International Development Assistance-only countries is available here: <https://datahelpdesk.worldbank.org/knowledgebase/articles/906519>.

22. The list of 17 blend countries is available here: <https://datahelpdesk.worldbank.org/knowledgebase/articles/906519>.

23. 15 Middle-income Emerging Markets with large GDP: Argentina, Brazil, Colombia, Egypt, India, Indonesia, Lebanon, Mexico, Philippines, Russia, South Africa, Thailand, Turkey, Ukraine, and Venezuela.

24. Seven lower middle-income countries: Angola, Bolivia, El Salvador, Eswatini, Morocco, Tunisia, and Vietnam.

25. 28 upper middle-income countries: Albania, Algeria, Armenia, Azerbaijan, Belarus, Belize, Bosnia, Botswana, Bulgaria, Costa Rica, Dominican Republic, Ecuador, Gabon, Georgia, Guatemala, Iran, Jamaica, Jordan, Kazakhstan, Mauritius, Montenegro, North Macedonia, Paraguay, Peru, Romania, Serbia, Sri Lanka, and Turkmenistan.

- In the case of 15 large EMs with a total of \$351.6 bn debt service payments, just \$21.1 bn (6%) is owed to bilateral creditors. The multilateral creditors account for \$33.9 bn (9.6%), but the bulk \$296.5 bn (84.3%) is owed to private creditors.
- Bonds with \$180.3 bn (52.2%) represent the biggest chunk of debt service payments owed to private creditors, followed by commercial banks \$95.9 bn (27.7%).
- Out of total \$4.4 bn of IMF debt service, IDA-only countries owe 0.9 bn (20.4%), and blend countries owe 1.1 bn (25%) of debt service obligations.

The growing weight of private-sector creditors adds to the complexity in the negotiations on debt relief and debt restructuring programs to help distressed EMDE sovereign borrowers.

Getting Debt Relief Right

Since March 2020, multiple initiatives have been launched by the IMF, World Bank, G20, G7, and others offering debt relief to poor countries to help them free up funds to fight the COVID-19 pandemic. On March 25, the IMF and World Bank issued a joint statement calling on all official bilateral creditors to suspend debt payments from IDA countries that request forbearance.²⁶ On April 13, the IMF gave debt service relief to 25 poor countries under its revamped Catastrophe Containment and Relief Trust (CCRT) as part of the Fund's myriad initiatives to help address the impact of the COVID-19 pandemic.²⁷

On April 15, the G20 Finance Ministers and Central Bank Governors adopted a Debt Service Suspension Initiative (DSSI) that allows the suspension of both principal and interest payments for the poor countries from May 1, 2020, to the end of 2020.²⁸ Backed by the Paris Club, the DSSI would benefit 77 countries (76 IDA-eligible²⁹ countries plus Angola). All G20 official bilateral creditors (including China) will take part in this initiative.

While these myriad debt service suspension initiatives, in principle, are welcome and would mitigate some financing pressures on the poor countries, but several shortcomings need to be addressed to make debt relief fair, substantial, and meaningful.

First, these initiatives offer temporary debt relief for a limited period, not permanent debt relief as sought by many poor countries.

Second, it is unclear whether the proposed debt relief would include government-guaranteed debt as well as debt issued by local governments and state-owned enterprises.

Third, a large number of poor countries owe substantial debt service payments to multilateral development banks (e.g., World Bank) and regional development banks (e.g., Asian Development Bank). There is no assurance that the debt service payments owed to multilateral and regional banks would also be covered despite the call by G20 to "explore the options for suspension of debt service

26. Joint Statement World Bank Group and IMF Call to Action on Debt of IDA Countries, March 25, 2020. Available at: <https://www.imf.org/en/News/Articles/2020/03/25/pr20103-joint-statement-world-bank-group-and-imf-call-to-action-on-debt-of-ida-countries>.

27. IMF Executive Board Approves Immediate Debt Relief for 25 Countries, Press Release, International Monetary Fund, April 13, 2020. Available at: <https://www.imf.org/en/News/Articles/2020/04/13/pr20151-imf-executive-board-approves-immediate-debt-relief-for-25-countries>.

28. G20 Finance Ministers and Central Bank Governors Meeting, Communiqué, April 15, 2020. Available at: [https://g20.org/en/media/Documents/G20_FMCBG_Communique%C3%A9_EN%20\(2\).pdf](https://g20.org/en/media/Documents/G20_FMCBG_Communique%C3%A9_EN%20(2).pdf).

29. IDA-eligible countries consist of 59 IDA-only and 17 blend countries.

payments.” As G20 member-countries are the largest shareholders of multilateral and regional development banks, it should be difficult to suspend interest and principal payments from May until at least end-2020.

Fourth, more importantly, private creditors (bondholders and commercial lenders) have not shown any willingness to join these initiatives by offering the same forbearance, despite the G20’s request. Until now, private creditors have also not responded favorably to the recommendation by the Institute of International Finance (a lobby group of the global financial industry) to “voluntarily grant IDA-eligible countries, upon request, debt payment forbearance for a fixed period.”³⁰

Without the participation of private creditors, the debt relief would be partial for a large number of poor and middle-income countries that owe substantial portions of debt service to private sector foreign creditors (see Table 3). From the perspectives of effectiveness and equity, the participation of foreign private creditors in voluntary standstills is essential, even if it is a time-consuming and complicated process. The private sector creditors who have enjoyed higher returns must also bear some risk and share the costs of imprudent risk-taking. By excluding private creditors, it would encourage them to take imprudent risks without suffering the consequences. Given the growing weight of private-sector creditors in EMDE financing, their involvement in debt relief and crisis resolution is a prerequisite.

There are various means to ensure the participation of private creditors in the forbearance. One option for official creditors is to insist on the “comparable treatment” clause in a Paris Club Agreed Minute that requires a country seeking debt relief from bilateral creditors should secure comparable debt relief from its private creditors. The “private sector involvement” (PSI) framework is another approach that was extensively used during the Latin American debt crisis of the 1980s. The 2009 Vienna Initiative is also a good example of successful cooperation between the public and private sectors. Given the magnitude of the current COVID-19 crisis, the creditor governments could also use informal powers to persuade their private institutions to participate in the standstills.

Private-sector creditors also need to recognize that it is in their economic self-interest to defer payments on comparable terms to avoid widespread sovereign defaults and subsequent renegotiations that could last many years, if not decades.

Fifth, there is a need to widen debt relief to lower middle-income and upper middle-income countries facing a high risk of debt distress. Therefore, the debt relief eligibility criteria should be expanded to include some non-IDA-eligible countries (such as Algeria, Egypt, Oman, El Salvador, and South Africa) facing high debt vulnerabilities. A standstill for LMCs and UMCs must also include all private creditors. As debt restructuring is already underway in Argentina, Lebanon, and Zambia, the involvement of private and multilateral creditors is crucial for the orderly debt resolution.

The COVID-19 crisis has renewed calls for a Sovereign Debt Restructuring Mechanism along with widespread inclusion of Collective Action Clauses (CACs) in future debt contracts.

30. IIF Statement Following the Conclusion of the G20 Finance Ministers and Central Bank Governors Virtual Meeting, Institute of International Finance, April 15, 2020. Available at: <https://www.iif.com/Press/View/ID/3856/IIF-Statement-Following-the-Conclusion-of-the-G20-Finance-Ministers-and-Central-Bank-Governors-Virtual-Meeting>.

The Need for Strong Fiscal Response

To support their economies, most EMDE central banks have cut benchmark interest rates and are pursuing expansionary monetary policies, akin to their developed economies counterparts. Only some countries (such as Colombia, the Philippines, Poland, and South Africa) have engaged in quantitative easing programs. Monetary measures can be useful to address a crisis that originated in the financial sector but are mostly ineffective tools to address COVID-19-induced shocks. Besides, EMEs cannot aggressively cut rates as it could trigger additional capital outflows and pressure on EM currencies.

Till now, only a few governments (such as Thailand, China, Malaysia, South Africa, and Peru) have responded with sizeable fiscal stimulus measures to support workers and businesses heavily impacted by the COVID-19 crisis. Others have either reallocated existing resources or announced a small fiscal package relative to GDP, India being a prime example. India's fiscal stimulus of \$22 bn (0.8 % of GDP) is grossly inadequate to support its \$3 trillion economy and lags behind most of its Asian peers such as Malaysia (16% of GDP), Thailand (15%), and Pakistan (2.7%).

What is needed is a strong fiscal policy response through massive public spending that would strengthen COVID-19 relief and recover efforts at the national level. In this context, EMDEs should not adhere to strict fiscal deficit targets and should adopt "whatever it takes" approach to fight the coronavirus-induced economic downturn.

First and foremost, governments need to increase health care spending to ensure the availability of essential medical and testing supplies, personal protective equipment, medical professionals, and isolation wards in hospitals.

The next priority should be to minimize bankruptcies and job losses, particularly in the labor-intensive, and MSMEs (micro, small, and medium enterprises) sectors. The MSMEs need a comprehensive financial package to overcome cash flow problems. Such a package could include tax relief, loan repayment holidays, credit guarantees, issuance of an overdraft facility, and new relief loans at concessional rates. A quick recovery is feasible if MSMEs remain in business.

A large share of the labor force in emerging market and developing economies is informal (for instance, 92 percent in India) with no assurance of wage protection and social security. Therefore, the fiscal measures should prioritize protecting the lives and livelihoods of informal workers and other economically vulnerable groups that are suffering disproportionately both from the pandemic and its economic fallout. Otherwise, COVID-19 could reverse the hard-won gains made on poverty in recent decades.

In countries such as India, Kenya, and Uganda, where direct cash transfers into bank accounts of beneficiaries are feasible, such digital payment platforms should be used to provide direct income support to poor and low-income households. Such measures can help in reducing poverty and inequality arising out of the COVID-19 crisis. Indeed, the momentum created by the COVID-19 pandemic provides an opportunity for EMDEs to develop comprehensive social protection and safety nets to protect the most vulnerable groups from future shocks.

Meanwhile, EMDEs undertaking extraordinary measures to tackle the COVID-19 pandemic need to remain vigilant of foreign investors launching claims under investor-state dispute settlement (ISDS)

provisions of bilateral investment treaties. Researchers at IISD have called for “governments to come together to suspend the application of treaty-based investor-state arbitration for all COVID-19 related measures or clarify how international law defenses apply to this extraordinary situation.”³¹

Why Financial Regulation Matters

Along with fiscal, monetary, and financial policies, the role of financial regulations to curb large capital outflows remains preeminent in preserving financial stability. In this regard, EMDE financial regulators must use capital controls and other regulatory tools to curb rapid capital flight that would induce financial instability in the face of large fiscal deficits.

For instance, the imposition of price-based capital control in the form of an exit tax could discourage foreign portfolio investors from pulling out money from financial markets immediately.³² The EMDEs could impose an exit tax initially for one year, and the tax rate could vary depending on the type and holding period of the investment.

Some advanced and emerging economies have already imposed a ban on short-selling in equity markets to maintain market integrity. This is indeed welcome and should be supplemented by strict regulation of high frequency and algorithmic trading that often exacerbates the sell-off in turbulent periods.

Regarding local currency bond markets, financial regulators should rethink on the enlarged presence of short-term portfolio flows that tend to be highly volatile and pro-cyclical and enhance EMDEs’ vulnerability to external financial shocks. The policy priority should be to develop a deep domestic institutional investor base and allow only long-term institutional investors (such as sovereign wealth funds) with overall caps on foreign holdings.

Currency Swaps and Repo Facility: No Game Changer

In the face of the COVID-19 pandemic, the US Federal Reserve announced the establishment of temporary dollar liquidity arrangements (swap lines) to provide easy access to dollar funding outside the US. On March 19, the dollar swap lines of up to \$60 bn each were made available to four emerging markets (Brazil, South Korea, Mexico, and Singapore).

On March 31, the US Fed also announced the establishment of a temporary repurchase agreement facility for foreign and international monetary authorities (FIMA repo facility) under which foreign central banks can temporarily exchange their US Treasury securities for the US dollar from the Fed. According to the Fed, the repo facility is meant to “help support the smooth functioning of the US Treasury market by providing an alternative temporary source of US dollars other than sales of securities in the open market.”³³ Simply put, the primary objective of the repo facility is to ensure the smooth functioning of the US Treasury market that could be potentially destabilized by a fire sale of Treasuries by foreign central banks.

31. Nathalie Bernasconi-Osterwalder, Sarah Brewin and Nyaguthii Maina, Protecting Against Investor–State Claims Amidst COVID-19: A call to action for governments,” Commentary, April 2020, Available at: <https://www.iisd.org/library/investor-state-claims-amidst-covid-19>.

32. Kavaljit Singh, “Regulation will have a role in managing the fallout,” Letter, Financial Times, April 13, 2020. Available at: <https://www.ft.com/content/f145cca8-7b4b-11ea-af44-daa3def9ae03>.

33. Federal Reserve announces establishment of a temporary FIMA Repo Facility to help support the smooth functioning of financial markets, Press Release, March 31, 2020, Federal Reserve, Available at: <https://www.federalreserve.gov/newsevents/pressreleases/monetary20200331a.htm>.

It is too early to assess the impact of these two temporary facilities. However, the latest IIF statistics reveal that till April 15, Korea (\$12 bn), Singapore (\$5 bn), and Mexico (\$6.7 bn) have used a small portion of the US dollar swap lines, while little pick-up of the repo facility has yet occurred.³⁴

By design, the FIMA repo facility could potentially benefit China, India and a few other EMEs that hold large US Treasury securities as part of their forex reserves. It is of no use to those EMDEs that don't hold US Treasury securities in their reserves.

A Well-resourced and Reformed IMF

On April 9, the IMF Board doubled the resources of Fund's twin emergency financing facilities — the Rapid Credit Facility (RCF) and the Rapid Financing Instrument (RFI) — to \$100 bn to meet the large financing needs of its emerging market and developing country members. The RCF is available only to low-income countries and carries a zero-interest rate with a final maturity of 10 years. While the RFI is available to all members but charges a 1.5 percent interest rate with a shorter repayment period (3¼ to 5 years) and comes with conditionalities, such as debt sustainability and policy reforms requirements, that may delay the approval of disbursement.

At the time of writing, close to 100 countries have placed requests for emergency financing. Civil society groups have demanded that the IMF should relax financing terms and preconditions under the RFI facility at least until the COVID-19 crisis is over.

While considering COVID-19 related loan requests, the IMF Board should not politicize decisions. Loan requests by member-countries (such as Venezuela and Iran) should not be rejected because of their political differences with the US, the biggest shareholder of the Fund.

Although the IMF has announced that its member-countries can draw on the Fund's \$1 trillion lending capacity to fight against the COVID-19, but analysts estimate that the Fund's current maximum lending capacity is \$787 bn.³⁵ As some 130 member-countries (including middle-income countries such as South Africa) may seek financial assistance from the IMF this year, the onus is on the US and other large shareholders of the IMF to augment its lending resources.

One option for the IMF is to request some members having substantial forex reserves (such as China, Japan, and Germany) to increase their bilateral lending arrangements.

Another option for the IMF is to issue one-time new Special Drawing Rights³⁶ (SDRs), similar to the allocation of 161.2 bn SDRs (equivalent to \$250 bn) in 2009 in the wake of the global financial crisis. Since the COVID-19 pandemic is a crisis of an entirely different magnitude and requires a response of an unprecedented scale, the IMF could issue new SDRs equivalent to about 1 trillion (\$1.3 trillion). By doing so, EMDEs would receive more than \$500 bn based on their 42 percent quota shares at the IMF. An additional benefit of SDRs is that members can lend their SDRs to those who need them.

34. Elina Ribakova, Benjamin Hilgenstock, Jonathan Fortun, and Esther Grambs, "Macro Notes – COVID-19 Policy Response in Emerging Markets," Institute of International Finance, April 15, 2020. Available at: <https://www.iif.com/Publications/ID/3845/Macro-Notes-COVID-19-Policy-Response-in-Emerging-Markets>.

35. Edwin M. Truman, "The IMF will need more resources to fight the COVID-19 pandemic," Peterson Institute for International Economics, March 29, 2020. Available at: <https://www.piie.com/blogs/realtime-economic-issues-watch/imf-will-need-more-resources-fight-covid-19-pandemic>.

36. Created in 1969 by the IMF, special drawing right is an international reserve asset whose value is defined on the price of a basket of five currencies: the US dollar, euro, Chinese renminbi, Japanese yen, and British pound sterling. The SDRs are allocated to member countries in proportion to their IMF quotas. An IMF member can transfer SDRs to another member and receive credit in a convertible currency.

At the International Monetary and Financial Committee meeting held on April 16 during the virtual IMF and World Bank spring meetings, the US opposed the proposal to issue new SDRs. Without the backing of the US, the prospects of raising additional funds through new SDRs are bleak. Nevertheless, the IMF member-states should explore making use of existing 204 bn SDRs (equivalent to about \$281 bn) to meet the immediate financing needs of EMDEs while persuading the US to support the issuance of new SDRs.

Along with governance reforms of the IMF, there is an urgent need for a strong global financial safety net. The existing arrangements comprising of international reserves, central bank bilateral swap arrangements, and regional financing mechanisms (such as the Arab Monetary Fund, Latin American Reserve Fund, BRICS Contingent Reserve Arrangement, and Chiang Mai Initiative Multilateralization) are fragmented and lack coordination at the global level.

ODA Has a Unique Role to Play

The official development assistance (ODA) can make a real difference in containing the spread of the virus and reducing the human and economic costs of the COVID-19 pandemic. Not only bilateral aid agencies are quick to respond to a health emergency, but, more importantly, they have considerable experience of working with diverse stakeholders — local and national governments, multilateral agencies, and non-governmental organizations. Their expertise in the delivery of health and other essential public services in poor countries is well recognized.

Except for Sweden and a few others, not many developed countries have met or exceeded the United Nations' target of spending at least 0.7 percent of gross national income on ODA. Even though the COVID-19-induced recession, as well as the demands for increased domestic spending in developed countries, may lead to a substantial reduction in global ODA levels but the challenge is to upscale aid commitments, given its unique characteristics.

No Country is an Island

The human costs of the COVID-19 pandemic are rising across the world. As of April 21, more than 2.4 million people have been sickened, and at least 164,000 people have died by COVID-19 pandemic. There is hardly a country in the world unaffected by the COVID-19 crisis or its associated economic impacts.

Most health experts believe that it may take 12 to 18 months to develop a vaccine against the coronavirus. Even if a vaccine is quickly developed, the World Health Organization, pharmaceutical companies, national governments, and international agencies need to ensure that the vaccine will be affordable and accessible to billions of people who need it.

It is difficult to accurately estimate the economic and financial impacts of the COVID-19 pandemic, as there are several unknowns such as how long the coronavirus will last and how long economic disruptions will continue. Nevertheless, one thing is clear: the coronavirus does not respect borders. Nor does it distinguish across economies. The policy response to COVID-19 pandemic needs to be guided by an overarching principle: No one country is safe until every country is safe.

Make no mistake: If emerging and developing economies suffer a deep economic and financial crisis, it would generate significant spillbacks effects on advanced economies as well. Hence, enhanced multilateral cooperation is a sine qua non for preventing the spread of COVID-19 and minimizing its economic and financial shocks.

